Internal Revenue Service
memorandum

CC:TL:Br3
MNelson

[redacted]
TL-N-1737-90
CC:TL:Br3 Nelson Coe
I.R.C. section 832(c)(4)
Losses incurred deduction

date: FEB 7 1990

to: Regional Counsel, Midwest Region CC:MW

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]
Docket No. [redacted]

This is in response to your request for advice from the Tax Litigation Division on the "mortgage guaranty" insurance issue in the case identified above.

ISSUE

May petitioner deduct as part of the unpaid loss portion of the losses incurred deduction provided by section 832(c)(4) estimates of amounts ultimately payable on mortgage loan contracts that are in default by year's end but for which foreclosure proceedings have not yet been initiated or completed by the insured.

FACTS

The request for advice does not contain a summary of the facts in this case. The following summary was developed from information separately provided to us by the trial attorneys assigned to the case.

The adjustments at issue here were made to [redacted]s [redacted] (collectively referred to herein as "[redacted]") for the taxable years ending [redacted]; [redacted]; and [redacted]. During those years, [redacted] underwrote mortgage guaranty insurance for financial institutions for their secured residential and commercial real estate loans. Most of the coverage during the years in issue was provided under policy form [redacted] (first mortgages) and policy form [redacted] (second mortgages).

The policies were noncancellable by the insurer and were either annually renewable policies or single premium policies under which a single premium payment purchased coverage for a term or for several years. The majority of the contracts were renewable annually. We do not have any information with respect

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to how premiums were remitted to [redacted] or whether premiums were due only until a borrower went into default or until a claim was filed. This could be a significant fact; we recommend you ascertain whether an insured was obligated to continue premium payments beyond initial default. See discussion pp. 19-21, infra.

Under the applicable policy, [redacted] insured the lender against "loss of the mortgage loan," subject to certain terms and conditions. The significant terms are set forth below:

> 8. NOTICE ON DEFAULT
>
> Within ten (10) days after any Borrower's account is four (4) months in default the insured must give notice thereof to the Company. The insured must thereafter give the Company monthly reports indicating the default status of such Borrower's account until such time as title to the real estate security for the mortgage loan has been vested in the insured, or such Borrower's account is less that two (2) months in default.
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> 9. PROCEDURE ON DEFAULT
>
> When any Borrower's account is in default four (4) months or more, the Company may direct the insured to commence appropriate proceedings (as defined in Paragraph 21c of this Policy) with respect to the real estate security for the mortgage loan. In any event, when any Borrower's account becomes six (6) months in default, the insured must commence such proceedings unless the Company gives written consent to a delay in such proceedings on such terms and conditions as the Company may prescribe. When such proceedings are instituted, the insured must diligently pursue them; and if applicable law permits the appointment of a receiver, the insured must make application therefor with the recommendation that an agent of the Company be appointed to act as such receiver. The insured must furnish the Company within a reasonable time, with copies of all notices and pleadings filed or required in such proceedings and with any pertinent information requested by the Company. The insured must also furnish the Company, at least fifteen (15) days prior to any foreclosure sale, with a statement indicating the amount anticipated to be due to the insured at the time of such sale, as determined under the provisions of this Policy; and the insured must bid at least such amount at such sale. Even if a Borrower's account is in default less than four (4) months, the insured may at any time either accept a voluntary conveyance of the

Borrower's interest in the real estate security for the mortgage loan or commence appropriate proceedings with respect there to and no such action shall preclude the insured from recovery for loss under this policy.

10. COMPUTATION OF LOSS

The amount of loss payable to the insured shall be limited to the unpaid principle balance due under the mortgage loan agreement, accumulated interest computed at the contractual rate provided therein through the date of the tender of conveyance (penalty interest excluded), real estate taxes and hazard insurance premiums necessarily advanced by the insured, any reasonable and necessary expenses incurred by the insured in the preservation of mortgaged real estate, and all necessary expenses of any appropriate proceedings, including court costs and reasonable attorney's fees not exceeding three percent (3%) of such unpaid principal balance and accumulated interest.

11. WHEN LOSS PAYABLE

Any loss due to the insured is payable within sixty (60) days after the insured files a claim for such loss on the form furnished by the Company. Such claim for loss must be accompanied by a tender to the Company of conveyance of title to the mortgaged real estate, together with satisfactory evidence that such title is good and merchantable in the insured and free and clear of all liens and encumbrances. If the insured fails to file a claim for loss within sixty (60) days after conveyance of title to the insured, such failure shall be deemed an election by the insured to waive any right to claim payment under the terms of this Policy.

12. OPTIONAL SETTLEMENT PROVISION

In the event of claim for loss under this Policy, the Company may at its option, in lieu of taking title to the real estate security on a defaulted mortgage loan and paying the loss computed in accordance with Paragraph (10) of this Policy, pay to the Insured the Optional Settlement Percentage of the loss so computed. In such event, the Company will have no rights in such real estate and such payment to the insured will constitute a full and final discharge of the Company's liability on such claim.

. . .

21. DEFINITIONS

(a) The term "months in default" **means that** failure of a Borrower to pay **the aggregate** amount of a specified number of monthly payments due under the terms of a mortgage loan.

Form 2033, which was used for second mortgages, requires notice of default to [redacted] after the borrower is two months in default (instead of four), and the measure of damages under paragraph 10 includes any costs incurred in curing the delinquency on a first lien instrument if so directed by [redacted].

For the taxable years prior to [redacted], [redacted] used a "loss ratio" method to compute the unpaid loss portion of the losses incurred deduction (this unpaid loss portion is also referred to herein as "loss reserves").[1] Under this method, additions to the loss reserves were based upon a percentage of premiums earned during the year. This method was used because [redacted] did not have enough experience to use the "case basis" method. The "case basis" method, which [redacted] began using in [redacted], uses loss experience to estimate loss reserves required by state insurance regulations. These regulations typically require a "reserve" for claims reported and unpaid and claims incurred but not reported, which state laws define as including (i) estimated losses on insured loans that have resulted in the conveyance of property that remains unsold; (ii) insured loans in the process of foreclosure; and (iii) insured loans in default for four or more months.[2] These regulations also reflect the views of the National Association of Insurance Commissioners ("NAIC").[3]

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[1] Although the unpaid loss portion of the losses incurred deduction is often referred to as a "loss reserve," such a term is a misnomer. A "reserve" represents an estimate of future, <u>unaccrued</u> claims. <u>See</u> Treas. Reg. § 1.801-4; <u>see also</u> section 461. As explained on pages 8-21, <u>infra</u>, property and casualty companies do not get to deduct loss "reserves". They may only deduct actual "incurred" losses.

[2] Please note that this definition of "incurred but not reported" differs from the tax meaning of that term. <u>See</u> discussion at pp. 10-13, <u>infra</u>.

[3] The [redacted] report on mortgage insurance prepared for the [redacted] that you provided to us acknowledges that the case basis method includes estimates of losses that have not actually occurred. <u>See</u>, e.g., section II(c), p. 18, "Alternative Reserving Philosophies," in which the

On its tax returns, [redacted] took a deduction for losses incurred that included, in addition to its paid losses, its "loss reserves", i.e., either an amount representing a percentage of its premiums written or its case basis reserves. [redacted] alleges that it adjusts its unpaid loss reserve by the unearned premiums on policies covering delinquent loans. We have assumed for the discussion herein that [redacted] is also excluding the unearned premiums on delinquent loans from income as part of its unearned premium reserve under section 832(b)(4). We recommend verifying these assumptions. See discussion pp. 19-21, infra.

The notice of deficiency adjusted the loss incurred deduction to include as an unpaid loss only the amounts [redacted] would eventually be required to pay on insurance policies covering loans for which foreclosure proceedings had been concluded and title acquired (or for which title had been acquired by conveyance in lieu of foreclosure) prior to the end of the year. In other words, the taxpayer's return position is that notice of default is when a loss occurs under section 832(b)(5). The statutory notice position is that acquisition of title is when a loss occurs. We understand that at trial the taxpayer intends to argue that the initial default (i.e., one missed mortgage payment) is when a loss occurs.

Legal Analysis

[redacted] is a stock property and casualty insurance company taxed under the provisions of section 831 et seq.[4] Section 832(a) defines "taxable income" to mean gross income as defined by section 832(b)(1), less the deductions allowed by section 832(c). In general, under section 832(b)(1), the term "gross income" means the sum of

> (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and

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actuary's reserving philosophy of "establishing a reserve . . . to provide some assurance that adequate funds will be available to cover . . . potential liabilities" is compared to an accountant's GAAP requirement of establishing a loss reserve "only for losses that occurred with reasonable certainty over the exposure period covered by the policy, on the assumption that this reflects costs related to premium revenue." (emphasis added)

[4] All references to and descriptions of sections of the Internal Revenue Code and Treasury Regulations are to those in effect for the tax years in issue, unless otherwise stated.

investment exhibit of the annual statement approved by the National Association of Insurance Commissioners [the "NAIC"],

(B) gain during the taxable year from the sale or other disposition of property,. . .

and

(E) in the case of a company which writes mortgage guaranty insurance, the amount required by subsection (e)(5) to be subtracted from the mortgage guaranty account.

"Underwriting income" is defined by section 832(b)(3) to mean only the premiums actually earned on insurance contracts during the taxable year less losses incurred and expenses incurred. The term "premiums earned on insurance contracts during the taxable year" means the amount of gross premiums written on insurance contracts during the taxable year, minus return premiums and premiums paid for reinsurance, increased by the unearned premiums on outstanding business from the previous year and reduced by unearned premiums on outstanding business for the current year.

Under section 832(b)(5), "losses incurred" are computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding year.

Section 832(b)(6) defines "expenses incurred" to mean "all expenses shown on the annual statement approved by the National Association of Insurance Commissioners" except "there shall be deducted from expenses incurred . . . all expenses incurred which are not allowed as deductions by subsection (c)." Among the deductions allowed under section 832(c) are "(1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade and business expenses)" and "(4) losses incurred as defined in subsection (b)(5). . . ."

Section 1.832-4(a)(2) of the Treasury Regulations provides in part:

(1) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable

> year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the [NAIC], as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61 . . . .
>
> (2) The underwriting and investment exhibit [of the annual statement form prescribed by the NAIC] is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose.

Sections 1.832-4(a)(5) and 1.832-4(b) provide:

> (5) In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director, are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to the actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

The point of disagreement between the Service and [redacted] is over whether the "unpaid loss" portion of the "losses incurred" deduction allowed by section 832(c)(4) and defined by section 832(b)(5) properly includes estimates of amounts the petitioner will have to pay to lenders for insured losses on mortgage loans that petitioner reasonably estimates were in default status by year's end. In support of its position, petitioner argues that a default is the root cause of any loss on a mortgage loan eventually suffered by an insured and compensated for by petitioner, that the insurance company's liability to the insured attaches when a loan goes into default, and that the actual deduction taken reflects, by its size, the fact that many loans in default do not actually result in loss or in claims filed and paid. (The reasonableness of the size, in contrast to the timing, of the deduction is not in issue.) Petitioner will probably rely in part on the unreported opinion in The Banking Center v. American Mortgage Insurance Co. Inc., No. 78-269-CIV-5 (E.D.N.C. 1981), aff'd No. 81-2147 (4th Cir. 1982), in which an insurance company underwriting similar policies was held to be obligated to compensate the insured for its loss on a mortgage loan because the company was the insurance carrier when the default initially occurred, despite the fact that the insurance had lapsed by the time the insured acquired title. We can also expect petitioner to argue that:

(1) Industry custom, insurance experts, the NAIC, and state regulators treat default as a loss event;

(2) Insurance company tax reporting requirements are not as strict as those imposed on regular corporate taxpayers;

(3) The Service's proposed method of accounting for losses treats petitioner like a regular corporation or a cash basis taxpayer and does not allow for "incurred but not reported" losses, which are allowable under the Service's own rulings; and

(4) Any tax advantage available to insurance companies under petitioner's reporting method has been removed by the discounting provisions of section 846, enacted in 1986, and respondent's position here, if correct, would make section 846 unnecessary.

The Service's position is that section 832(b)(5) defines "losses incurred" as restricted to only actual losses or damages already suffered by the insured and compensable under the applicable insurance contract. This includes damages suffered by the insured during the tax year that the insurance company does not yet have knowledge of ("incurred but not reported" or "IBNR" losses). It also includes damages suffered by the insured during the tax year that the insurance company initially resists paying but in a later taxable year pays ("resisted" losses). Rev. Rul. 70-643, 1970-2 C.B. 141. It does not include "reserves," i.e., future unaccrued losses or estimates of damages the insurance company expects its insureds will suffer in the future (and for which the insurance company will eventually pay) based on events that occur only in part during the year. Rev. Rul. 61-167, 1961-2 C.B. 130. Because the lender has not actually yet suffered a loss compensable under the insurance policy when a borrower falls behind in his or her mortgage payments, the petitioner has not incurred a loss within the meaning of the statute. It is only when the insured acquires title to the property securing the loan, the value of which is insufficient to provide the lender with the amount due it under the loan agreement (as measured by paragraph 10 of the insurance policy), that the insured suffers an actual loss or damages compensable under the insurance policy. Prior to that time, no insured loss (paid or unpaid) has been incurred by the lender or by the insurance company, and no deduction under section 832(c)(4) is allowable. The fact that state regulations or NAIC reporting requirements instruct insurance companies to establish a reserve based on events occurring in part during the year does not mandate a tax deduction for such reserves. Rev. Rul. 61-167.

The Service position in this case is based upon several general principles relevant to the taxation of property and casualty insurers that we would like to argue to the Tax Court. These principles are:

(1) The words used in section 832 and the accompanying regulations should be given their commonly understood meanings;

(2) Property and casualty insurers are accrual basis taxpayers, and any exception to regular accrual accounting rules must be based on an express statutory directive and not on whether the tax incident is unique to the insurance industry;

(3) Regulatory accounting rules as set forth by the National Association of Insurance Commissioners are not controlling for tax purposes;

(4) "Reserves" for losses, per se, are not provided to property and casualty insurers under the Internal Revenue Code;

(5) A deduction for "losses incurred" is not available to an insurance company prior to the time its insured has actually suffered damages; and

(6) State laws imposing liability upon insurance companies are not determinative of when a tax deduction accrues.

The plain meaning of the Code and regulations supports our position in this case. The statute refers to "losses incurred" and not to "losses to be incurred," and the regulations require that any deduction be for actual losses. The statute's use of the past tense and the regulation's use of a word that means existent as opposed to potential is in accordance with the rules of accrual accounting, and the Tax Court opinions in this area support our position that [redacted] is an accrual basis taxpayer that has taken a premature deduction.

Cases construing section 832(b)(5)

The first opinion to analyze whether an "unpaid loss" had occurred within the meaning of section 832(b)(5) was Modern Home Life Insurance Co. v. Commissioner, 54 T.C. 935 (1970), acq. 1970-2 C.B. xx. Despite our loss in Modern Home, the Tax Court's holding in that case is completely consistent with our position in the present case. The insurance contracts in Modern Home provided that in the event of a debtor's complete disability, the insurer was obligated to pay a debtor's monthly mortgage payments during the period of disability. The taxpayer deducted as unpaid losses incurred the sum of the monthly mortgage payments due and owing in the taxable year at issue, plus its estimate of its total liability for mortgage payments that would become due and owing in the next year from those debtors who were sick or disabled by December 31 of the taxable year. The size of the deduction for unpaid losses, which was not in dispute, was based on a physician's estimate of the number of months the disability would continue. The Service disallowed the deduction of all amounts in excess of the mortgage payments due by December 31.

The Service argued that the petitioner's liability for the total losses deducted was not fixed because part of the payments were contingent on the continuing disability of the insureds and that "event" did not happen during the taxable year. The Tax Court disagreed. In holding that Modern Home was entitled to deduct currently its entire estimate of amounts to be paid in the future, the court held that the regulations merely require that the insurance company's obligation to pay "something" to become fixed before the end of the year. 54 T.C. at 940. Because Modern Home computed unpaid losses by reference only to those borrowers who were actually disabled during the tax year, an obligation to pay "something" on each mortgage was fixed by the end of the taxable year. In the present case, [redacted] has no obligation to pay anything with respect to a particular loan merely because the borrower has defaulted on the loan. There is no obligation to pay anything unless and until the borrower surrenders title and the insured actually suffers damages.

The Tax Court's opinion in State of Maryland Deposit Insurance Fund Corporation v. Commissioner, 88 T.C. 1050 (1987) ("MDIF"), is also on point and completely supports our position. The petitioner in MDIF was a property and casualty insurance company taxable under section 831 et seq. The taxpayer provided two basic services to Maryland savings and loan associations and their customers; it monitored the operations and finances of member associations and it insured customer deposits. Within the scope of its insurance function, MDIF provided three types of insurance-related protection, viz., (1) advances to or (2) financial assistance agreements with member associations and (3) payments to customers upon the occurrence of an event of default.

It was this latter type of insurance-related coverage that was in issue in the case; it reimbursed deposits to individuals and entities who had savings accounts with member associations. The obligation to make such payments was triggered by an "event of default" as described in the taxpayer's by-laws (the functional equivalent of an insurance policy). Section 2-703 of those by-laws provided as follows:

> Section 2-703. Events of Default. No payment shall be made by [MDIF] with respect to its insurance liability . . . unless an event of default shall have occurred with respect to any member, as defined by these By-Laws . . . . As used in these By-Laws, . . . the term "event of default" shall mean for any member (A) its adjudication in bankruptcy . . . , (B) the appointment of a conservator for its affairs by a court . . . or (C) the appointment of a receiver for its affairs by a court . . . .

The tax years in issue were 1974-1982. No "events of default" occurred until 1985, when conservators were appointed for several member associations.

On its tax returns, MDIF reported as the unpaid loss portion of its losses incurred deduction amounts it claimed represented "incurred but not reported" losses for the years in issue. These amounts were estimates, computed with the assistance of an economist and consultant to financial institutions, of amounts MDIF expected to pay in the future for losses attributable, claimed the petitioner, to events occurring in the taxable years in issue. The petitioner argued that because acts of mismanagement and fraud occurred during the tax years in issue and these acts directly led to the appointment of conservators in 1985, it was entitled to deduct losses attributable to those bad acts in the years in which the acts occurred. Petitioner presented the testimony of an expert who testified to the reasonableness of the reserve and the likelihood of occurrence of loss.

The Tax Court accepted the reasonableness of the size of the petitioner's loss reserve and found that MDIF was perhaps correct in arguing that in all probability many of the acts and events causing the "events of default" occurred during the years in issue. Indeed, the court acknowledged that MDIF's total cost for the collapse of the Maryland savings and loan industry far exceeded the claimed IBNR deductions. The court rejected, however, MDIF's contention that the losses were incurred within the meaning of section 832 when the acts of mismanagement and fraud occurred. The court observed that sections 832(b)(5) and 832(c)(4) provide that an unpaid loss deduction is only allowable if the event that fixes the taxpayer's obligation to pay something occurs before the end of the year.

> The authorities are clear . . . that the calculation of IBNR losses must be based on estimates of actually incurred losses as of the end of the year. This is to be distinguished from an impermissible calculation based on estimates of potential losses that might be incurred in future years . . . . We are fully cognizant of the disastrous insurance-related losses [MDIF] incurred in 1985. The Federal income tax laws, however, do not allow an insurance company (other than a life insurer) to build up a contingent loss reserve over a period of years in anticipation of such future losses . . . . As we stated in Modern Home Life Insurance Co. v. Commissioner [54 T.C. 935, 939 (1970)], "a deduction for IBNR losses will only be allowed for a loss resulting from the occurrence of an event which fixed liability prior to the close of the taxable year." [The bad] acts . . . would not support loss deductions with respect thereto by [MDIF] unless and until they constituted an event of default under [MDIF] by-laws, until they resulted in an insurance-related payment by [MDIF], or until they gave rise to an obligation to make such a payment. (emphasis added)

88 T.C. at 1060, 1061, 1062. In other words, an incurred loss deduction is not allowable prior to the time the event occurs that obligates the insurance company to pay something. Accordingly, because MDIF had no fixed liability to pay anything under the insurance coverage unless and until one of the three specified events of default occurred, no loss was "incurred" prior to the occurrence of such an event and no deduction for an "unpaid loss" was allowable. And because [redacted] has no obligation to pay anything on a contract that has merely been reported to [redacted] as being in default by the end of the year, no loss is incurred under section 832(b)(5).

Our position here also finds support in Maryland Savings-Share Insurance Corporation v. United States, 226 Ct. Cl. 487, 644 F.2d 16 (1981) ("MSSIC"). In that case, which involved earlier taxable years of the petitioner in MDIF, the taxpayer argued that certain acts occurring during the years in issue caused member savings and loan associations to undergo events of default in later years and that these acts represented present losses to the insurer that necessarily resulted in the reporting of losses in later years. The taxpayer introduced expert testimony designed to show that events in the years in issue made the appointment of a conservator probable in later years and the deduction for IBNR losses accurately quantified the total loss payable under that probability. The court was unconvinced. It found that under the by-laws, MSSIC was not obligated to pay anything except upon the occurrence of an event of default; it held that the taxpayer's deduction was not an estimate of an actual loss but, instead, an estimate of a probable loss. "No provision in the Code allows a deduction for a reserve for such a contingency." 644 F.2d at 28.

The MDIF and MSSIC cases are directly analogous to the instant case. Here we have an insurance company characterizing as an unpaid loss reserve amounts that represent a reasonable estimate of losses it may become obligated in the future to pay because of events that occurred only in part during the taxable years in issue. That is, [redacted] argues that a missed mortgage payment - a default - begins the process that often results in the payment of a claim by [redacted] and therefore default (or notice of default - [redacted] has two different positions) is a reasonable and appropriate time to increase its unpaid loss reserve. Our response to this argument is that section 832(b)(5) requires that the taxpayer's liability to pay something must be fixed before the end of the tax year but under the insurance contracts in issue here, [redacted]'s liability to pay something was not fixed unless and until its insureds acquired title to the mortgaged property and suffered damages. Before that time, compensable damage to the insured under the insurance policy had not actually occurred. The insured is still looking to the borrower and the security for repayment of the insured loan. The fact that an event occurred during the year in issue that causes [redacted]'s liability to attach and make a payment if a loss is eventually suffered by the insured does not enable [redacted] to take a current deduction.

In Modern Home and MDIF, the Tax Court held that an insurance company is not entitled to the unpaid loss deduction until the occurrence of the event that fixes the insurance company's liability to pay something; at such a time, a deduction is allowed even if the insurance company does not actually know of the particular loss (IBNR) and even if actual payment is not made until years later. This event, as a practical matter, coincides with when the insured actually sustains the insured-against damage.[5] Although it may very well have been true in MDIF that specific bad acts by savings and loan association directors directly led to the appointment of conservators, the insured-against loss event - customer loss of deposits into the savings and loan associations - did not happen until a conservator was appointed. Up until that time, a depositor could withdraw his funds, and no damage compensable under the insurance contract was suffered, notwithstanding the precarious financial condition of the financial institution. Because the damage to depositors was only potential and not actual before a conservator was appointed, the insurance company's obligation to pay something was not "fixed" and the deduction for losses insured

[5] Here is where it would be helpful to establish at trial the fact that financial institutions do not treat a mortgage loan that is four months in default as a loss.

was not allowable. See State of Arizona v. Glens Falls Insurance Company, 125 Ariz. 328, 609 P.2d 598 (1980) (insurance company that issued a policy to the State of Arizona under which it agreed to be liable only for damages occurring within the policy period was not obligated to defend the State against a negligence suit brought by savings and loan depositors when the policy lapsed prior to the appointment of a conservator for the savings and loan association; actual damages did not occur until a conservator was appointed, despite the continuous insolvency of savings and loan association). In the present case, the insured-against event is "loss on the mortgage loan." Until the lender acquires title to the securing property, the lender is still looking to the borrower and the borrower's equity in the securing property to satisfy the indebtedness on the mortgage loan. Thus, the "damages" insured against have not yet occurred, and [redacted] has no fixed obligation to pay anything.

The decision in The Banking Center v. American Mortgage Insurance Company, Inc., No. 78-269-CIV-5 (E.D.N.C. 1981), aff'd No. 81-2147 (4th Cir. 1982), does not defeat our point. In that case, the defendant ("AMIC") wrote mortgage guaranty insurance under a policies substantially identical to those issued by [redacted]. The Banking Center ("TBC") failed to pay the annual premium on the due date of October 4, 1974, or within the 45 day grace period, and AMIC terminated the coverage by a letter dated November 19, 1974. Meanwhile, on November 1, 1974, a borrower defaulted on his mortgage contract and never made another payment. TBC subsequently attempted to foreclose on the security, but the borrower's bankruptcy proceedings prevented TBC from acquiring title until June 8, 1976. AMIC refused to compensate TBC for the deficiency realized on the foreclosure on the primary grounds that the insurance policy was not in force when the damages occurred.

The district court first ascertained when the policy lapsed. It concluded, based on contract language and applicable North Carolina law, that the policy was not terminated on October 4, 1974, when the unpaid premium was due, but was in force until November 19, 1974, the date on which it was cancelled by AMIC. Thus, the insurance was still in place when the borrower first defaulted on the loan.

The next question for the district court was whether AMIC was liable on a policy in force when default first occurred but no longer in force when actual damages were sustained. The court agreed with AMIC's argument that TBC "realized no loss on its loan until 1976," slip op. p. 9. The court nonetheless concluded that AMIC was liable to TBC for the losses sustained in 1976, well after the insurance coverage lapsed. The district court held that the policy covered "loss sustained by reason of default" and that coverage included all losses ultimately realized attributable to events beginning during the period of coverage. Because "[t]he event insured against was in progress when the policy expired, . . . the loss resulting from the event should be recoverable." Id.

Despite the holding of the district court in AMIC that the occurrence of a default during the policy period that eventually results in loss constitutes "loss sustained by reason of default" for purposes of determining when coverage under the insurance policy attached, that event is not when a loss is "incurred" within the meaning of section 832(b)(5). The district court did not hold that the loss was realized or incurred in 1974, when default first occurred. Indeed, it considered 1976, the year of acquisition of title, as the year in which the loss actually occurred. Rather, the court merely held that the applicable insurance coverage for which AMIC was liable included loss sustained after termination of the contract so long as the first of the "chain of events" contemplated by the contract as leading to an insurable loss occurred during the period of coverage.

Even though one court imposed liability on the insurance company despite the fact that damages occurred after the policy expired and the other court did not, the holding of the district court in AMIC is entirely consistent with the holding of the Arizona Court of Appeals in Glens Falls, supra. Notwithstanding the continual insolvency of the savings and loan association in Glens Falls, damages to the depositors were only potential and not actual until the time a conservator was appointed and the depositors were prohibited from withdrawing their deposits. The reason AMIC was liable when the damages were sustained after coverage terminated and Glens Falls Insurance Company was not is because the insurance coverage in Glens Falls was expressly limited to actual damages occurring within the policy period, whereas the district court in AMIC held that no such limitation was included in the insurance policies written by AMIC. It is only when damages are actually sustained by the insured, however, that losses are incurred by insurance company under section 832(b)(5). Even the district court in AMIC agrees that the actual loss on the mortgage loan occurred in 1976, the year acquisition of title, and not in 1974, the year of default.

The rules of accrual accounting apply to [redacted]

In support of its determination that the petitioner had taken a premature deduction, the Service argued in Modern Home that continued disability was an "event" distinct from the initial disability and that the occurrence of such an event was a prerequisite to the taxpayer's obligation to pay the amounts it deducted. In holding for the petitioner, the Tax Court stated that the rules for deductibility under sections 832(c)(4) and 832(b)(5) are more lenient than the rules applicable to regular accrual basis taxpayers. While this may be true in general, the "leniency" goes not to whether the insurance company's obligation to pay "something" must become fixed in the first instance. Instead, the leniency is that an insurance company may take a loss deduction based on its estimate of how many of its insureds have actually suffered damages during the year instead of waiting until it has actual knowledge of a loss or agreeing that it owes the insured. See United States v. General Dynamics Corp., 481 U.S. 239 (1987); Rev. Rul. 70-643, 1970-2 C.B. 141. Only the event that gives rise to the obligation to pay something must have happened during the year; the insurance company need not know of it or agree that it is obligated to pay something to be entitled to the deduction. In this manner, the accounting rules applicable to insurance companies are more "lenient" than those applicable to regular accrual taxpayers. The rules applicable to both insurance companies and regular accrual taxpayers require that the obligation "to pay something" must arise during the taxable year. This point is illustrated by a comparison of the holdings in MDIF and Modern Home to the Tax Court's holding in Burnham Corporation v. Commissioner, 90 T.C. 953 (1988), aff'd 878 F.2d 86 (2d Cir. 1989).[6]

The petitioner in Burnham, which was not an insurance company, settled a lawsuit by agreeing to pay the plaintiff a fixed monthly amount for the duration of her life. The agreement unconditionally obligated the petitioner to make the first 48 monthly payments regardless of whether the plaintiff lived during that period. Subsequent payments were dependent on plaintiff's survival. The first payment was due in December 1980. By consulting reliable life expectancy tables, petitioner determined that the plaintiff would live for 16 more years. Petitioner argued that it was entitled to deduct in 1980 the total of 16 years of payments.

The Service argued that the petitioner had not satisfied the first part of the "all events" test applicable to accrual taxpayers under section 461. Specifically, the Service contended that all of the events that bear on the fact of liability for the total amount deducted had not occurred prior to the end of the tax year because the petitioner's liability after the initial 48 month period was contingent upon the plaintiff's continued survival, which had not yet occurred. In rejecting this argument, the Tax Court found that by entering the settlement agreement in 1980 the petitioner's obligation to pay something was fixed. There were no further events that had to occur before the petitioner had to begin paying; only the amount of the

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[6] Please note that the Service has not acquiesced in Burnham. This discussion is merely to illustrate that the Tax Court is applying a similar analysis to insurance company obligations as to noninsurance company obligations.

liability was yet to be determined. Accordingly, the first prong of the "all events" test was met.

Despite the fact that in Modern Home the Tax Court observed that the rule for deductibility under section 832(c)(4) was different from the rules generally applicable to an accrual taxpayer, the difference lies not with whether a taxpayer's obligation to pay something must be fixed by the end of the taxable year. That is, had the petitioner in Modern Home not had the benefit of section 832 and had the court's holding in Burnham been the applicable law for purposes of deciding Modern Home, Modern Home still would have been entitled to the same deduction. As stated previously, while it may be true that property and casualty insurers get some relief from the all events test, that relief comes in the form of resisted losses and not in the form of a reserve for a contingent future loss.[7]

NAIC reporting rules

One typical taxpayer argument that you should expect will be made in this case is that state regulatory requirements and the rules of the National Association of Insurance Commissioners require mortgage guaranty insurers to establish loss reserves by reference to borrower default. Our answer is that these rules are not determinative of the tax result. Although there is language in some Tax Court opinions that suggests homage must be paid to NAIC reporting, the courts now acknowledge that NAIC reporting must defer to the rules of accrual accounting if the NAIC method does not provide a clear reflection of income. Of course, this is consistent with the holding of the Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), and

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[7] A series of articles on the taxation of property and casualty insurance companies appeared after the enactment of the Revenue Act of 1942. These articles were written by Charles W. Tye, then the Tax Counsel to the Maryland Casualty Company. In the course of discussing new section 204 (now sections 831 and 832), which recodified much of prior law specifically affecting the industry, Mr. Tye made the following observation:

> At this point, it might be well to emphasize two basic reminders, namely: Reserves as such, whether or not required by law, are not deductible by companies taxable under section 204; and the annual statement approved by the National Convention of Insurance Commissions is not conclusive for tax purposes either as to the Company or the Commissioner irrespective of the provisions of Section 204(b) [now section 832] of the Code.

"Federal Income Taxation of Insurance Companies Other Than Life or Mutual" Tye, 21 Taxes 199, 200 (1943).

so the cases that contain unfavorable language regarding the deference owed to NAIC reporting may be explained as being simply pre-Thor Power. None of the opinions issued since 1979 show such deference to NAIC reporting.

For example, this point was recently made by the Supreme Court in Colonial American Life Insurance Co. v. Commissioner, ___ U.S. ____, 109 S. Ct. 2408 (1989). In that case, the taxpayer argued that NAIC reporting requirements determine proper tax accounting. In rejecting this contention, the Supreme Court stated:

> . . . NAIC practices do not apply where their application would be inconsistent with accrual accounting rules . . . . Under petitioner's interpretation, the fundamental question [at issue] would be answered by simple reference to accounting procedures in the industry. It is inconceivable that Congress intended to delegate such a core policy determination to the NAIC.

109 S. Ct. at 2415. This point also is illustrated by the opinions in City Investing Company v. Commissioner, T.C. Memo. 1987-36, aff'd sub.nom. Home Group, Inc. v. Commissioner, 875 F.2d 377 (2d Cir. 1989), petition for cert. filed Oct. 24, 1989.

The petitioner in City Investing sold multiyear insurance policies through agents. Policyholders had the option of prepaying the entire premium due or of paying in yearly installments. Premiums were paid to the agent, who deducted the commissions due and remitted the balance to petitioner. Not until premiums were actually paid to the agent by the policyholder was the petitioner obligated to pay commissions attributable to such premiums. If a policy was cancelled, petitioner returned to the agent any unearned portion of the premium, less any commission attributable to the unearned portion. The agent was not entitled to a commission pertaining to any portion of the premiums attributable to the period following the date of cancellation.

Regardless of the method of payment selected by the policyholder, petitioner recorded the entire amount due on the policy as premiums written. Because federal taxable income under section 832 is based on premiums earned, however, the petitioner excluded from income all of the deferred and unpaid premiums (as well as those amounts paid but not earned by the end of the year). In accordance with NAIC requirements, however, the petitioner deducted the entire commission attributable to the gross premium written.

The Service argued that the commissions were not deductible under section 832(c)(1), which imposed on the petitioner the requirement that expense must be "incurred" (the same requirement imposed on deductibility of losses by section 832(c)(4) and 832(b)(5)) to be deductible and that the petitioner failed to satisfy this test. In agreeing with the Service, the Tax Court held that the petitioner was on an accrual method of accounting as modified by the requirements of section 832. The court then looked to section 7701(d)(25) for the definition of "incurred". That section provides that "paid or incurred . . . shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A." The Tax Court then held that "incurred" as used in section 832 has the same meaning as when applied to other accrual taxpayers and therefore the "petitioner must meet the timing requirements on this deduction in the same manner as any other taxpayer under an accrual method of accounting." Because the petitioner did not include in income the premiums for which it claimed the commission expense deduction, its method of reporting did not clearly reflect income, and the court held that its use of NAIC methods must give way to the ruling accrual accounting. Because the petitioner's liability to pay the commissions was not fixed unless and until the premiums were paid to petitioner, under the rules of accrual accounting no deduction for the commissions was allowable before that time.

In affirming the holding of the Tax Court, the Court of Appeals for the Second Circuit observed "that the intent of Congress in originally enacting the provisions of the Code relating to property and casualty insurance companies demonstrates only that the Statutory Method was to be used as the starting point for tax accounting." 875 F.2d at 381 (emphasis in original). See also Western Casualty & Surety Co. v. Commissioner, 65 T.C. 897 (1976), aff'd 571 F.2d 514 (10th Cir. 1978); Commissioner v. General Reinsurance Corp., 190 F.2d 148 (2d Cir. 1951) (statute prevails over NAIC method where the two conflict); Pacific Insurance Company Ltd. v. United States, 188 F.2d 571 (9th Cir. 1951); Cf. Gerling International Insurance Co. v. Commissioner, 839 F.2d 131, 134 n.6 (3d Cir. 1988) (section 162 prevents an insurance company from deducting expenses not yet actually paid or incurred); contra, Fidelity and Deposit Co. of Maryland v. United States, 177 F.2d 805 (4th Cir. 1950); New Hampshire Fire Insurance Company v. Commissioner, 146 F.2d 697 (1st Cir. 1945).

You should expect [redacted] to cite Bituminous Casualty Corporation v. Commissioner, 57 T.C. 58 (1971), acq. in result only, 1973-2 C.B. 1, in support of its position that NAIC rules govern the application of section 832. Despite some unfavorable language for the Service in this opinion, the holding of the opinion does not support [redacted]'s argument either on the primacy of NAIC reporting methods or on the definition of losses incurred. Indeed, depending on what information is developed regarding unearned premiums, we may be able to cite Bituminious as support for our contention that [redacted] took a premature deduction.

The issue in Bituminous was whether the petitioner's reserves for premium rebates was properly included in its reserve for unearned premiums under section 832(b)(4). The petitioner issued policies under which the standard premium charged would be adjusted up or down depending on the loss experience of the company with respect to such policies or in accordance with the gross amount of premiums written. The final amount of the rebates actually credited could not be computed until substantially after the end of the policy term because the actual amount of losses incurred for the term often was not determinable until much later. In part this was due to the fact that Bituminous did not compute its rebates actually credited on the basis of its estimates of incurred unpaid losses but instead waited to revise its estimates to correspond to the amounts actually paid. See 57 T.C. at 61. Nonetheless, for NAIC and tax reporting purposes, the petitioner computed a reserve for rebates that consisted of its year-end estimate of that portion of the earned premiums that would ultimately be refunded to policyholders as rebates. On its returns, petitioner reduced its underwriting income by its increase in its rebate reserve. In other words, it treated its rebate reserve as a reserve for unearned premiums.

Bituminous appears to be damaging for the Service in the present case because the Tax Court described the reserves as "contingent" and yet held for the taxpayer. A close reading of the opinion reveals, however, that the "contingency" referred to by the court is not with respect to the petitioner's obligation to rebate something based on events happening during the tax year but with respect to the determination of the precise amount due. That is, under the facts found by the Tax Court in Bituminous, the taxpayer had an obligation to credit some amount of rebate on premiums by the end of the year, although recognition of that obligation and ascertainment of the precise size of the obligation might not have occurred until after the close of the tax year. As explained above, uncertainty as to size of payment due or lack of acknowledgment of the obligation to make a payment are not impediments to deductibility under the Service's interpretation of section 832. If an uncertainty still exists with respect to whether a taxpayer will be obligated to pay anything, however, then a deduction is not permissible under section 832.

The Tax Court's holding in Bitiminous is merely that section 832(b)(4) excludes from underwriting income amounts that an insurance company is obligated to return to the policyholder as a reduction to the gross premium charged even though those amounts may only be estimated by year's end. These amounts constituted part of the insurance company's "unearned premium reserve." The court describes an unearned premium reserve as follows:

> The function of the unearned premium reserve (in which the reserve for [rebates] is included) is to separate from the gross premiums received by the insurer that portion (earned premium) available to the insurer to do with as it chooses from that portion (unearned premium) necessary to meet the insurer's future obligations on its policies. The unearned premium reserve is intended in part to provide for reinsurance of the insurer's policies in the event of its insolvency and <u>to provide for the insurer's continuing obligations in force, including losses</u>, loss expenses, and the obligation to return premium such as retrospective rate credits. (emphasis added).

57 T.C. at 62. <u>See also</u>, report of Arthur D. Little, Inc., <u>supra</u>, at 17. "The unearned premium reserve covers a potential risk that endures for the policy term."

It is the unearned premium reserve that is intended to cover [redacted]'s cost of future losses on the insurance policies. [redacted] has already excluded the unearned premiums from underwriting income under section 832(b)(4). Allowing a loss incurred deduction on the same policies when premiums are still to be earned would allow [redacted] a double deduction, which is specifically prohibited by section 832(d).

Thus, [redacted]'s method of accounting for losses does not clearly reflect income, and the Service is therefore entitled to correct [redacted]'s method of accounting. It is important to remember that the mortgage insurance policies are very different from most other kinds of casualty insurance policies, e.g., automobile insurance policies, under which a policyholder could have a current loss but still have coverage for future losses in the same policy year. Once a loss is incurred under the mortgage guaranty insurance, the policy is over because the loan agreement is no longer in force. That is, there is no reason for future premium payments or an unearned premium reserve once the loss is incurred. And yet, [redacted] apparently maintains an unearned premium reserve for loans in default. This would be unnecessary if loss is incurred when a loan is merely in default.

<u>Other taxpayer arguments</u>

In 1986, Congress added section 846, which in general requires insurance companies taxable under section 831 <u>et seq</u>. to discount their unpaid losses. This section was added to reduce the benefit of the time value of money accruing to insurance companies who were permitted a current deduction under section 832(c)(4) for amounts the company may not pay until several years later. [redacted] is likely to argue that if our position in this case were correct, Congress would not have needed to add section 846. This is incorrect, however.

Section 846 entails the use of different discount factors tailored to fit the time value of money benefit inherent in a particular line of business. Some lines, e.g., medical malpractice, often have several years elapsing between the incurrence of the loss as defined in this document and the time of payment. Other lines, such as mortgage guaranty insurance, do not have much time elapsing between the loss event and the claim payment. Such is the nature of the business and the payment terms of the contract. For such lines, the discount will be small. Under the standard for section 832(b)(5) expressed herein, it is still possible for [redacted] to incur the loss in one tax year but not pay the claim until another tax year. Thus, the addition of the discounting provisions by Congress in 1986 does not mean that our pre-1986 definition of unpaid losses is incorrect.

[redacted] may also argue that we have removed IBNR and put [redacted] on a cash basis of accounting by not allowing [redacted] to take a deduction when a mortgage loan goes into default. Under our standard for deduction under section 832(c)(4), however, [redacted] is still capable of including within its computation of unpaid losses some losses that are "incurred but not reported." For example, [redacted] is entitled to a deduction for an amount it estimates, based on its experience, it will pay later on insurance policies covering mortgages for which foreclosure proceedings have been completed and a loss on the loan has been realized. That is, suppose [redacted] knows from experience that between November 10 and December 31 of each year approximately [redacted] foreclosure proceedings are concluded that eventually cause the insureds to suffer losses, which total $[redacted]. Because the policies only require an insured to file a claim within 60 days of acquisition of title, none of the insureds have actually filed a claim for those losses by December 31. Because [redacted] may pay the claim for up to 60 days after the claim is filed, it will not actually pay that $[redacted] until after December 31. Nonetheless, every year [redacted] may deduct the $[redacted] (discounted after 1986) as part of its unpaid loss portion of its loss incurred deduction. It has an IBNR deduction of $[redacted], and it has a deduction sooner as an accrual basis taxpayer than it would have as a cash basis taxpayer. The fact that the "window" is not large does not mean the "window" does not exist. IBNR is intended to catch year-end accrued losses, not to provide a reserve for future, unaccrued losses.

CONCLUSION

For the reasons set forth above, [redacted] may not deduct its estimates of amounts eventually payable on policies covering mortgage loan contracts that are in default but for which the insured has not completed foreclosure proceedings by year's end. Should you have any additional questions, please call Maureen Nelson (FTS) 566-3335.

MARLENE GROSS

By: ____________________
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